

Message Text

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ACTION TRSE-00

INFO OCT-01 EA-06 ISO-00 CIAE-00 PM-03 H-01 INR-07 L-02

NSAE-00 NSC-05 PA-01 PRS-01 SP-02 SS-15 USIA-06

AID-05 COME-00 EB-07 FRB-03 XMB-02 OPIC-03 CIEP-01

LAB-04 SIL-01 OMB-01 STR-01 CEA-01 NEA-09 IO-10 /098 W

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FM AMEMBASSY MANILA

TO SECSTATE WASHDC PRIORITY 999

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USADB

FOR NAC AGENCIES

E.O. 11652: N/A

TAGS: EAID, EFIN, RP

SUBJECT: COST OVERRUNS: PHILIPPINE POWER PROJECTS

REF: MANILA 1813

SUMMARY. ADB IS STILL CONDUCTING APPRAISAL OF GOP REQUEST FOR SUPPLEMENTARY LOAN OF \$24.4 MILLION TO FINANCE COST OVERRUNS ON MINDANAO POWER PROJECTS. ALTHOUGH SUBJECT WILL NOT COME UP AT ADB BOARD UNTIL APRIL, EMBASSY BELIEVES THAT EXAMINATION OF COST OVERRUNS SHOULD BE UNDERTAKEN IN CONSTRUCTIVE SPIRIT DIRECTED TOWARD ACCOMPLISHMENT OF PROJECTS AND THIS APPRAISAL IS PROVIDED TO THAT END. EMBASSY WILL PROVIDE FURTHER ANALYSIS AND RECOMMENDATIONS ON PHILIPPINE COST OVERRUNS ONCE APPRAISAL DOCUMENT IS ISSUED AND CAN BE EXAMINED IN DETAIL. END SUMMARY

1. REFTEL REPORTED GOP REQUEST TO ADB TO FINANCE \$24.4 MILLION COST OVERRUNS ON FIRST AND SECOND LIMITED OFFICIAL USE

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MINDANAO POWER PROJECTS. BANK IS STILL CONDUCTING

APPRAISAL OF SUPPLEMENTARY LOAN PROPOSAL AND IS NOT EXPECTED TO HAVE ITEM ON AGENDA OF BOARD UNTIL APRIL. APPRAISAL DOCUMENT SHOULD THEREFORE BE AVAILABLE SOMETIME LATE THIS MONTH.

2. EMBASSY WILL BE PROVIDING ITS ANALYSIS AND RECOMMENDATIONS AS SOON AS APPRAISAL DOCUMENT IS ISSUED AND CAN BE EXAMINED IN DETAIL. IN MEANTIME, HOWEVER, EMBASSY WISHES TO OFFER FOLLOWING PRELIMINARY COMMENTS TO SUPPLEMENT INFORMATION PROVIDED IN REFTEL.

3. BASICALLY, ACCORDING TO ADB INFORMATION DOCUMENT 16-75 OF FEBRUARY 4, 1975, COST OVERRUNS ARE DUE TO CHANGE IN SCOPE AND DESIGN; ESCALATION OF COSTS OF MATERIALS; DEVALUATION OF U.S. DOLLAR; AND CHANGES IN CURRENCY ALIGNMENTS. THIS JUDGMENT IS RENDERED AFTER AN ELAPSED PERIOD OF FOUR YEARS OF TURBULENCE IN PRICING AND WORLDWIDE LIMITATIONS ON SUPPLY OF ELECTROMECHANICAL EQUIPMENT.

4. AS A CLUE TO ESCALATION OF COSTS, LOCAL INDUSTRY SOURCES HAVE INDICATED THAT PRICES OF U.S.- MADE TURBINES AND GENERATORS HAVE GONE UP IN A RANGE OF 50 PERCENT TO 90 PERCENT BETWEEN 1971 AND 1975. FOR THERMAL TURBINES AND GENERATORS IT HAS BEEN ON THE HIGH SIDE OF 90 PERCENT. ONE MAJOR FACTOR HAS BEEN COST EXPLOSION IN EXOTIC METALS SUCH AS TITANIUM, TUNGSTEN, MANGANESE, ETC. HYDRO TURBINES AND GENERATORS, HOWEVER, USE STAINLESS STEEL AND COPPER AND COST ESCALATION HERE IS PROBABLY ABOUT 50 PERCENT.

5. MAJOR SUPPLIER IS JAPANESE (TOSHIBA) WITH OTHERS BEING INDIAN (TATA) AND TAIWANESE. GIVEN U.S. DOLLAR DEVALUATION AND HIGHER JAPANESE RATE OF INFLATION, IT MAY BE REASONABLE ASSUMPTION THAT JAPANESE-MADE TURBINES AND GENERATORS HAVE GONE UP IN PRICE AT HIGHER RATES THAN COMPARABLE U.S. -MADE EQUIPMENT.

6. IN SUM, EMBASSY BELIEVES THAT THE HARD REALITIES OF ENERGY CRISIS, INTERNATIONAL PRICE MOVEMENTS, DISTURBANCES IN THE AVAILABILITY OF MATERIALS, THE CORRESPONDENT HEDGING LIMITED OFFICIAL USE

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ATTITUDES PREVAILING IN MAJOR MARKETS AND RELATED FACTORS OF THESE DEVELOPMENTS IN THE PHILIPPINES HAVE RENDERED INEVITABLE COST ESCALATIONS OF THE ORDER INVOLVED IN THE PROJECTS AT ISSUE. EXAMINATION OF THIS PROBLEM THEREFORE, HAS TO LOOK TO THE NEED FOR CONTINUING DEVELOPMENT PROGRAMS, IN THIS CASE, THE CREATION OF NEEDED POWER GENERATION AND TRANSMISSION CAPACITY, AND NOT TO TRUNCATING OR ABORTING SUCH PROJECTS MERELY BECAUSE COSTS HAVE RISEN.

THIS EMBASSY UNDERSTANDS IS ATTITUDE THAT WILL PROBABLY BE TAKEN BY OTHER ADB BOARD MEMBERS WHO WILL LIKELY GO ALONG WITH SUPPLEMENTAL WITH SOME PRO FORMA QUESTIONING.

7. INFLATION IS WELL-KNOWN FACT WHICH WILL NOT GO AWAY. GOP, AS OTHER GOVERNMENTS NO DOUBT ALSO DO, REALIZES THAT SUPPLEMENTARY LOAN WILL MEAN LESS ADB RESOURCES FOR OTHER ACTIVITIES IN PHILIPPINES. IT HAS INDICATED ITS AWARENESS OF SENSITIVITY OVER COST OVERRUNS AND HAS DECIDED TO ASSUME COST OF REINFORCING STEEL WHICH WAS ORIGINALLY PART OF LOAN FINANCING. HOWEVERN, GOP FACES UNANTICIPATED COST ESCALATIONS IN RESPECT OF OTHER DEVELOPMENT PROJECTS AND IS HAVING TO SPREAD ITS LIMITED RESOURCES TO COVER THESE, IF THE COUNTRY'S PRIORITY PROGRAMS ARE NOT TO SUFFER EXCESSIVE CUTS AND DELAYS. AT THE SAME TIME THE COUNTRY'S NET RESERVES ARE NOT AS COMFORTABLE AS THE GROSS POSITION APPEARS TO SUGGEST, WHT THE FACTS OF CONTINUING HIGH IMPORT COSTS AND A SOFTENING OF PRICES OF ALL IMPORTANT EXPORT PRODUCTS.

8. UNTIL APPRAISAL DOCUMENT IS ISSUED AND SUBJECT PLACED ON AGENDA OF ADB BOARD, EMBASSY RECOMMENDS THAT WE MAINTAIN OPEN MIND ON COST OVERRUN PROBLEM, BUT WE BELIEVE STRONGLY THAT UNLESS NEW AND SIGNIFICANTLY ADVERSE FACTS EMERGE FROM THE BANK'S APPRAISAL WE SHOULD SUPPORT ADB EFFORTS TO COVER THESE NEW ELEMENTS OF COST WHERE POSSIBLE.
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